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Economic Outlook

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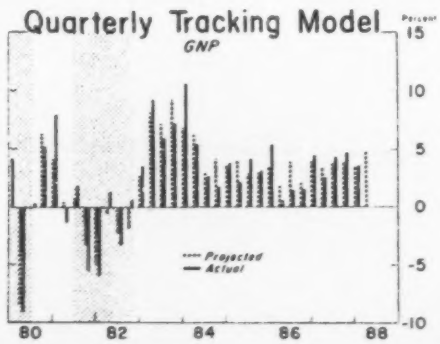
July 1988

The June employment numbers should lay to rest concerns that the economy slowed much in the second quarter. Instead, it appears that the basic strong growth trend established in early 1987 remains in force. The economy dipped slightly below this trend in the first quarter, as auto production dropped while dealers worked off excess inventories. But auto output rebounded sharply in the second quarter, suggesting that a pickup in GNP growth may surprise consensus forecasters, who have consistently underestimated the economy's strength during the past 18 months. Other statistics seem to confirm this pattern. The June purchasing managers' survey indicates the fastest growth since late last year when the economy was growing at a 4.8 percent pace. Under these conditions further increases in wage and price pressures are likely. While interest rate rises to date may hinder further acceleration in economic growth, they are probably not enough to slow the economy appreciably, given the strong business environment throughout the industrialized world.

Employment gains last month were widespread with both goods and services industries showing solid increases. In the manufacturing sector most of the additional jobs were in the durable goods sector, notably fabricated metals and machinery, which are major beneficiaries of business's capital spending spree. The Bureau of Labor Statistics diffusion index showed increases in about two-thirds of the industries surveyed, the greatest proportion so far this year. In addition to the good news on jobs, the wage inflation news was also favorable, with upward pressures moderating after some hefty increases earlier. But wage pressures should build if, as seems likely, strong employment growth continues this year. The aggregate hours index, which is arguably the best coincident indicator of economic growth, showed a strong increase in June and for the second quarter as a whole. Our GNP tracking model, which moves largely based on this indicator, predicts almost five percent growth for second quarter GNP (See chart).



Our official output forecast is about a percent lower, however, as a larger than usual proportion of the hours increase was attributable to younger workers, who are typically less productive than average.

Growing levels of imports and exports are spurring healthy gains in those economic sectors responsible for distributing tradable goods through the economy. Vendor performance, which measures the percentage of companies reporting slower deliveries, reached 70 in June, the highest level of the

year. An index of rail freight prices, which was flat from 1984 through 1987, is increasing at a double-digit annual rate so far this year. Strong export demand has pushed capacity utilization to the highest level since 1980. The purchasing managers' report focused attention on some of these potential inflation "hotspots" including longer lead times and shortages of some basic materials. Price pressures are still building in the producer pipeline where primary and intermediate goods prices are increasing about twice as fast as final goods prices. The strong conditions reported by the purchasing managers are in sharp contrast to the growth forecast given by Alan Greenspan in his Humphrey-Hawkins testimony. The Fed forecast implies a significant slowdown in economic growth during the last half of 1988. There is, however, little evidence of a slowdown in the leading indicators for June, which will most likely show a sizable increase. As the Fed chairman emphasized, inflationary pressures will tend to increase unless the economy slows from its recent pace.

All things considered, it seems unlikely the economy will slow in line with Fed expectations. Instead, it looks like the basic pattern of strong export and investment demand, mixed with modest consumer demand growth, will continue. As long as the labor market remains strong, it is unlikely consumers will cut back. Rising rates will damp housing starts, but it is hard to see how 1988 growth will drop below three percent without a heavier step on the brakes.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual 1987 II	1987 III	1987 IV	1988 I	Forecast 1988 II	1988 III	1988 IV	1989 I	Actual 1986-1987	Forecast 1987-1988	Forecast 1988-1989
Consumer Spending	1.2	3.5	-1.7	2.4	1.6	1.1	0.9	0.8	1.3	1.3	0.8
Business Investment	1.3	2.8	0.2	2.4	1.6	0.9	0.8	0.7	0.1	1.5	1.1
Residential Investment	-0.2	-0.4	0.4	-0.5	-0.1	-0.1	-0.1	-0.2	0.0	-0.1	-0.2
Change in Inventories*	-1.6	-1.5	4.9	-2.0	0.1	0.3	0.4	0.5	0.4	0.2	0.0
Net Exports	0.3	-0.6	0.3	1.6	0.4	0.7	0.7	0.8	0.3	0.6	0.6
Government Purchases*	1.5	0.5	0.7	-0.3	0.3	0.3	0.3	0.3	0.8	0.3	0.4
Real GNP	2.5	4.3	4.8	3.6	3.9	3.2	3.0	2.9	2.9	3.8	2.7

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual 1987 II	1987 III	1987 IV	1988 I	Forecast 1988 II	1988 III	1988 IV	1989 I	Actual 1986-1987	Forecast 1987-1988	Forecast 1988-1989
Nominal GNP	6.3	7.3	7.3	5.1	7.7	8.0	8.2	8.4	6.0	7.0	8.3
GNP Deflator	3.5	2.8	2.7	1.4	3.8	4.6	5.0	5.4	3.0	3.0	5.4
Corporate Profits After Tax#	10.0	9.0	8.7	11.8	10.4	7.2	6.7	6.4	8.4	9.2	6.4

Monthly Economic Indicators

	Recent Data Apr.	May	June	Actual 1987	Forecast 1988	1989
Consumer Price Index** (%)	0.4	0.3	n.a.	4.4	4.8	6.4
Industrial Production (%)	0.5	0.5	0.4	3.7	5.2	3.0
Retail Sales (%)	-0.5	0.3	0.5	5.1	5.4	5.2
Auto Sales (million units, a.r.)	10.5	10.2	10.6	10.3	10.3	8.8
Housing Starts (million units, a.r.)	1.58	1.38	1.45	1.63	1.45	1.35
Unemployment Rate (%)	5.4	5.6	5.3	6.2	5.4	5.2
Merchandise Trade Balance ($ bn., a.r.)	-123.6	-131.2	n.a.	-171.2	-145.0	-110.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. July 19, 1988
#Quarterly data are year-over-year percent changes.
a.r. = annual rate